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Supreme Court of the United States

OCTOBER TERM, 1944.

No. 191.

JOHN K. BERETTA, PETITIONER,

versus

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITIONER'S REPLY TO THE BRIEF FOR RESPONDENT IN OPPOSITION.

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SUBJECT INDEX.

LIST OF AUTHORITIES.

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Under leave of the Court, Petitioner herewith presents a short reply to Respondent's Brief. The reasons prompting this are—

FIRST: Since the filing of the Petition and Supporting Brief, the Second Circuit Court of Appeals, speaking through Judge Augustus N. Hand, has handed down another decision, in direct conflict with the decision of the courts below, to-wit: *Estate of Edward T. Bedford, Title Guaranty & Trust Co., Executor, vs. Commissioner of Internal Revenue,* (as yet unpublished), a copy of which is set out in appendix of this brief;

SECOND: Respondent's Brief, when properly analyzed, constitutes a virtual confession of error.

UNDISPUTED MATTERS.

It will be noted that the "Question Presented", as posed in Respondent's Brief, is shorn of the factual element of a want of intent or purpose to completely liquidate or dissolve. Apparently, this is because no issue is taken with Petitioner on such intent not being essential to a partial liquidation by a single distribution, as distinguished from one of a series of distributions. On pages 12-13 of Respondent's Brief, it is admitted that the authorities relied upon by Petitioner (Pet. 7) so hold, and conceded that "they may be inconsistent with the decision below as to the necessity for a liquidating intent" (here meaning intention to *wind up or dissolve*), and Petitioner on his part makes no question about the absence of such intent, under the facts.

Thus, the most insistently repeated basis for the decision below is destroyed[1].

This matter is not briefed by Respondent because regarded as "immaterial" in view of the "controlling issue" (Respondent's Brief 11-12)—whether a reduction in the par value of corporate stock can be a complete cancellation or redemption of a part of such stock (Pet. 7, 32).

As affecting this one indisputable issue, the facts adduced in Respondent's Brief (2-5), though fuller than set out in the Petition (2-4), in no way vary the latter, and it is to be noted that Respondent does not try to give any effect to the additional corporate history stated in the paragraph extending from page 2 to page 3 of his Brief.

Respondent's Brief does not in terms admit that the Honorable Judge writing the opinion for the Circuit Court of Appeals herein got somewhat tangled in the intricacies

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1 The necessity of the intent to dissolve is mentioned in every paragraph of the opinion (141 Fed. p 454-5) discussing the contention of partial liquidation, syllabi 1 to 4).

of income tax law when he undertook to declare, as additional basis for decision against Petitioner, that the distribution in question was made out of accumulated earnings and profits (Pet. 5-6, 12-13). Yet Respondent's Brief frankly says on page 6 that this distribution was out of accumulated earnings and profits and taxable, "*unless* it was a distribution in partial liquidation"; thereby plainly implying, just like the Tax Court[1], that, if this was a distribution in partial liquidation, it was not taxable[2].

Thus again, we return to the only thing disputed in this case, to-wit: Whether a reduction in the par value of a corporation's stock is a "complete cancellation or redemption of a part of said stock", within the definition of Section 115(i) of the 1936 Revenue Act.

The only facts possibly helpful for the determination of this matter, beyond those shown on pages 3-4 of Respondent's Brief or pages 2-4 of the Petition, are the following:

(1). The distribution to the stockholders was made from the enforced sale of the Mexican end of the bridge, a capital asset, in that the $135,000.00 distributed (out of which the taxpayer received $23,706.00) represented the net proceeds ($75,877.48) of the sale to the Mexican Government and most of the depreciation reserve ($62,029.89) attributable to the Mexican end of the bridge (R. 73, 23-4, 58-62).

(2). This sale represented a net capital loss of $68,-630.53 as against an investment cost in the Mexican end of the bridge of $206,536.90 (R. 60).

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[1] See its opinion as quoted on page 6 of the Petition.

[2] In addition to the cases cited on page 12 of the Petition as supporting this rule, see **Foster** vs. **United States**, 303 U. S. 118, 121, 58 S. Ct. 424, and **Fowler Bros. & Cox** vs. **Commissioner**, 138 F. (2d) 774, 776 (C. C. A.—6th), and the **Bedford** case, post, 16.

(3). The good faith of this distribution and the good faith of the reduction in the par value of the stock has never been questioned by the Commissioner.

(4). After this distribution, only the American side of the bridge was owned by Laredo Bridge Company, and, though it still operated so as to earn substantial dividends (R. 79), this sale of the Mexican end of the bridge "decreased the earnings of the company by about 40%" (R. 73).

WAS THIS "A DISTRIBUTION BY A CORPORATION IN COMPLETE CANCELLATION OR REDEMPTION OF A PART OF ITS STOCK"?

Purpose of the Law.

In undertaking to answer this question, Respondent's Brief gives no consideration to the reason behind the law, which must have been to exempt from ordinary income tax a stockholder's capital return on his investment. Accepting this as the purpose of the law, we can hardly imagine that it could be served (a) by construing "stock" in the above language of the law to mean *shares* or *certificates of stock*, or (b) by construing this language so as to exclude a complete cancellation of part of the value of each share, or (c) by construing this language to include a distribution in full cancellation or redemption of a part of the value of each share *only* when the corporation is in process of a complete liquidation, but to exclude a distribution in full cancellation or redemption when the corporation is making only a single distribution, without intended dissolution.

Looking to the substance of things, a restriction to *capital* values is the aim of this statutory definition.

THE WORD "STOCKS" IN THE DEFINITION.

The New York Court of Appeals in *Burr vs. Wilcox*, 22 N. Y. 551, 556, through Judge Selden, held that, though the word "stock" is "sometimes used to designate the certificates", "this is an *inappropriate* use of the word."

Cook on Stock, Stockholders and Corporations, Section 12, defines stock "as a proportionate part of certain rights in the management and properties of a corporation during its existence and in the assets upon its dissolution."

If Congress, in Section 115(i), was "speaking of *stock* in a broader sense than mere certificates", rather than making such latter inappropriate use of the word "stock", then, as suggested by presiding Judge Murdock in his dissenting opinion herein (R. 41), "there would be the same cancellation", "regardless of whether one-half of the stock certificates are cancelled, or whether the par value of each certificate is cut in two."

It would be a partial liquidation, within the law, when construed in the usual sense of the words used, when there was a complete (that is, full and absolute) cancellation or redemption of a part of the corporate stock. In other words, once we sever the word *"stock"* from the narrow meaning given it by Respondent, there would be a complete cancellation of a part of the *stock*, although there was only a partial cancellation of all of the stock certificates.

Can it be reasonably supposed that Congress intended to make an arbitrary distinction between capital values by including in this definition a corporate distribution in complete cancellation of a part of its stock certificates and at the same time excluding therefrom a corporate distribution in complete cancellation of a part of all of its stock?

The only thing suggested by Respondent, besides the Wilcox case, later discussed, post page 11, to support such

an arbitrary distinction is Article 115-5, Treasury Regulations 94. When, however, we read this Treasury regulation (Res. Br. 17-18), we find a definition absolutely identical in language with the law itself, and it is followed by several examples of "complete cancellation or redemption", the third and last of which is said to be "by the complete *retirement* of any part of the *stock*, whether or not pro rata among the shareholders."

Certainly, there is nothing more in this example than in the definition in the statute and regulations to require the meaning of *stock certificates* for the word *stock* as used therein. As for the word "retirement", this Court in *McClain vs. Commissioner*, 311 U. S. 527, 530, says;

> "In common understanding and according to dictionary definition the word 'retirement' is broader in scope than 'redemption'; is not, as contended, synonomous with the latter, but includes it. Nothing in the legislative history of the provision requires us to attribute to the term used a meaning narrower than its accepted meaning in common speech."

REDUCTION IN PAR VALUE.

Respondent does not claim any legislative history for this provision (Sec. 115[i]) that requires us to attribute to the term *stock*, any more than the term *retirement*, a meaning narrower than its accepted meaning in common speech. By construing "stock" to mean the stockholder's proportional interest in the corporation, we avoid the arbitrary distinction suggested in the question several paragraphs above. Congress, then, cannot be presumed to have used the word "stock" in a narrow and inappropriate sense when the ordinary meaning avoids inconsistencies and inequalities.

It is somewhat vaguely contended by Respondent that a reduction in the par value of corporate stock does not in any event constitute a complete cancellation or redemption of a part of such stock. No reason is given why the statute should be given the peculiar meaning claimed for it, and many reasons have heretofore been shown by us why it should not be so restricted. (Pet. 20-1, 24-5).

Of course, par value is face value, and face value is presumptive market value, and when the capitalization of this corporation was reduced by one-half and each share of its stock correspondingly reduced, each stock certificate was fully and completely cancelled in part; that is, to the extent of one-half, and any partial liquidation was thus effected.

We have in the Petition cited a number of cases holding that a reduction in the par value of stock was a complete cancellation or redemption of a part of such stock (7-8). Equally appropriate are other cases where there has been a reduction in capitalization by means of a reduction in the number of shares.

An example of this class of cases is found in *Kelly vs. Commissioner*, 97 F. (2d) 917 (C. C. A. 2nd), wherein in reducing the capitalization by one-half the number of shares was reduced from 160,000 to 80,000 and the same par value of $25.00 for each continued, and with reference to the sufficiency of such proceeding under Section 115(i), it was said by the Court, speaking through Judge Manton:

> "In the instant case it was a return of capitalization, not a dividend. The corporation returned to its stockholders 50% of the capitalization."

Another illustration of the same class of cases is found in *Commissioner vs. Quackenbos*, 78 F. (2d) 156 (C. C. A.—2nd), and still another in *Commissioner vs. Cordingley*, 78

F. (2d) 118 (C. C. A.—1st), for in both of those cases there was a reduction of capitalization effected by means of a reduction in the number of shares, rather than in the par value of each share.

Certainly, the capital loss is the same whether the reduction in capitalization be effected by means of diminishing the number of shares or by diminishing the par value of each share. The cases stand on a parity, and either form the reduction takes it is equally within the definition of Section 115(i).

And this brings us to the point that thus the distinction without a difference sought to be made by the Tax Court (See Petition 17-18, 27) is completely destroyed, for it will be recalled that the Quackenbos and Cordingley cases directly held that an intent to dissolve the corporation was not essential to a partial liquidation, such partial liquidation in those cases being effected by means of a reduction in corporate capitalization. We have in them a union of both features of the instant case, and the reason for the Tax Court's decision is thereby eliminated.

Malone vs. Commissioner, 128 F. (2d) 967 (C. C. A.—5th) (Pet. 22-4) is another case that belongs to this class where reduction of capitalization is attained by cutting the number of shares, and it, of course, exemplifies the reason for Judge Sibley's dissent in the case at bar. The argument of the Circuit Court of Appeals (bottom first column, 141 F. (2d 455), which is repeated again on page 7 of Respondent's Brief, that after the distribution the stockholders held the same proportional interest in the company's assets as before, is met by the holding of Judge Sibley, in the light of the fact recited by him that "each stockholder, of course, retained the same proportionate interest in the bank's assets he had before."

Coupling the language of this opinion with his dissent in our case, it is apparent that in the Malone case Judge Sibley virtually holds that a complete cancellation or redemption of a part of the corporation's stock is effected by a reduction in capitalization, regardless of whether this is accomplished by means of diminishing the par value of each share or by diminishing the number of shares.

PETITIONER'S PRINCIPAL AUTHORITIES REVIEWED.

The Circuit Court of Appeals herein gave no consideration whatever to the authorities cited on pages 7 and 8 of the Petition, though they were all pressed upon its attention. The opinion itself cites nothing but *Wilcox vs. Commissioner*, 137 F. (2d) 136, as supporting its holding that reduction in par value of stock is not a complete cancellation or redemption of a part of such stock.

Respondent, however, cites some additional authorities and undertakes to distinguish the cases relied upon by Petitioner.

He correctly says (Br. 9) that *Bynum vs. Commissioner*, 113 F. (2d) 1 (C. C. A.—5th), and *Commissioner vs. Straub*, 76 F. (2d) 388 (C. C. A.—3rd) do not involve a single distribution, but "one of a series of distributions". It is for this reason that it was necessary in those cases that there be an intent to dissolve the corporation, and it is precisely because of this that those cases emphasize the presence of such intent. But no reason has been, nor we believe can be*, given why the reduction in the par value of the stock comes within Subdivision (i) in one case and not in the other.

We therefore again stress the *Straub* case (Pet. 21) as being indistinguishable and in plain conflict with the deci-

*See Pet. 28.

sion below. The only distinction offered by Respondent is that the case involves "one of a series of distributions." What difference that makes as rendering a reduction in par value a complete cancellation or redemption of a portion of the stock is not explained.

Thus, in final analysis, Respondent's Brief stands on the same distinction without a difference undertaken to be made by the Tax Court.[1] That Court is just franker than Respondent about admitting the force of the *Straub* and *Bynum* cases, when it says that if this distribution had been one of a series—

> "then the fact that none of the corporation's shares were cancelled and retired as a result of the distribution would not be material and the method used of reducing the par value of the stock from $100.00 to $50.00 per share would be sufficient, and the cases of Bynum vs. Commissioner, 113 F. (2d) 1, and Commissioner vs. Straub, 76 F. (2d) 388, affirming 29 B. T. A. 216, would be in point."

Respondent's Authorities Reviewed.

On page 7 of Respondent's Brief several nonjudicial authorities are cited as supporting his contention. One of these is 1 Paul & Mertens, Law of Federal Income Taxation 432, where it is said:

> "A mere reduction of par value is not, *it would seem*, a redemption or cancellation."

Our emphasis is to show that this idea was not even agreed to by the authors, its basis being indicated as the opinion of the General Counsel of the Treasury Department,

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[1] See Pet. 27-8.

which is the same opinion partly set forth in the Tax Court's opinion herein (R. 33-4).

The interesting thing about this is that a comparison of the facts develops that the same identical case passed upon by the General Counsel was the one in which the taxpayer prevailed before the Second Circuit Court of Appeals in *Patty vs. Helvering*, 98 F. (2d) 717, the facts of which are virtually identical with the facts in the case at bar. Evidently, the Commissioner in that case disagreed with the opinion of his counsel, and therefore did not even assert that the distribution was not in complete cancellation or redemption.

This leaves virtually nothing but the *Wilcox* case to support Respondent's contention. The main distinctions in it we have previously pointed out (Pet. 26-7), they being in substance that there the distribution was taxable as being out of earnings and profits and that the several distributions there made were not out of the proceeds of a sale of capital assets as in our case.

Respondent's Brief (p. 78) criticizes the first of these distinctions by the suggestion that we have not even attacked the holding of the Circuit Court of Appeals herein that the distribution here was taxable as being out of earnings and profits. The reason why we did not do so is because we firmly relied upon the definite commitments of counsel for the Commissioner that, under the circumstances here present, this distribution, though out of accumulated earnings and profits, was not taxable if it was a distribution in partial liquidation.* We may add that we still firmly rely upon that commitment as shown in the first paragraph of the argument on page 6 of Respondent's Brief.

The second of the above mentioned distinctions may

*See ante, p. 2, for the Commitment, Note 2 for the Authorities.

be more fully and effectively stated in this wise: The amount distributed here was the proceeds of the sale of the Mexican end of the bridge and the depreciation reserve attributable thereto, and the corporation thereafter operated with diminished assets and 40% less profit. On the other hand, in the Wilcox case the distribution was not made out of any kind of capital assets, but out of excess earnings, and the business was thereafter operated without material curtailment. In our case there was a partial liquidation of the corporation, in the Wilcox case there was none.

Respondent says that the fact that there were no assets sold and no curtailment of business in the Wilcox case is "an immaterial difference." Of course, there must needs be a cancellation or redemption of stock in connection with such sale of assets, but it occurs to us that the fact that the distribution here involved was indisputably made out of a sale of capital assets, to-wit, the Mexican end of the bridge, constitutes not only a material difference, but strikes at the very heart of the idea of putting capital returns upon a different basis from ordinary income returns.

In addition, the distribution in the Wilcox case seems to have been made for the deliberate purpose of tax evasion, while there is no suggestion of that in our case.

ESTATE OF EDWARD T. BEDFORD, TITLE GUARANTY & TRUST CO., EXECUTOR, VS. COMMISSIONER.

This is the style of a case decided on August 8, 1944, by the United States Circuit Court of Appeals for the Second Circuit, the opinion being written by Circuit Judge Augustus N. Hand. Since this case is directly in point and is as yet unpublished, for the convenience of the Court we set out the opinion entire in an appendix hereto in accord-

ance with an official copy of the opinion furnished to us by the Clerk of the Court.

Like the *Straub* case, this case is directly in point on the second of the two propositions involved, whether reduction in par value of stock is a complete cancellation or redemption of a part of such stock. The decision of the Circuit Court of Appeals herein is therefore in direct conflict with the decision in the *Bedford* case.

The facts involved in the *Bedford* case are, in brief: The appeal involves income taxes of the estate of Edward T. Bedford, deceased, for 1937 (the same year as involved in the case at bar), and is taken from a decision of the Tax Court sustaining the assessment and adjudging a deficiency, and the Circuit Court of Appeals reverses the Tax Court. On account of a deficit in its surplus account, Abercrombie & Fitch Co. at a meeting of stockholders adopted a plan of recapitalization, under which the estate received in 1937, in exchange for its 3,000 shares of preferred stock, $100.00 par value, in that corporation, 3,500 shares of another class of preferred stock of the par value of $75.00; 1500 shares of its common stock of the par value of $1.00, and cash of $15.08 per share. The stock thus given in exchange was not subject to taxation because received through a re-organization under the provisions of Section 112(b)(3) of the Revenue Act, and the cash of $45,240.00 was concededly taxable as a part of the gain. The Commissioner, however, contended, and the Tax Court held, that the cash distribution, under the plan of re-organization, had "the effect of a distribution of a taxable dividend."

The corporation was not intended to be dissolved, though no discussion is made of this phase of the matter.

The Circuit Court of Appeals holds, in the first place, "that when earnings are once capitalized by the issue of stock dividends, they are no longer earnings, but capital,

except in cases where the purpose of the transaction is not an honest business transaction, but one to avoid taxation", and that "under those decisions (*Commissioner vs. Quackenbos*, 78 F. (2d) 156; *Patty vs. Helvering*, 98 F. (2d) 717; and *DeNobili Cigar Company vs. Commissioner*, 143 F. (2nd) 436), the distribution here was a liquidating dividend and not an ordinary dividend."

It holds in the second place, that even if the distributions "might have been taken out of accumulated earnings, these distributions should have been charged to capital rather than surplus".

Finally, and most important, it holds as follows:

> "The distribution here was a 'partial liquidation' because all of the old stock of the par value of $300,000.00 was surrendered by the decedent for new stock having a par value of only $264,000.00 (3500 shares of preferred stock with a par value of $75.00, and 1500 shares of common stock with a par value of $1.00). The transaction was evidently a distribution by Abercrombie & Fitch Co. 'in complete cancellation or redemption of a part of its stock.' Such a distribution is a partial distribution as defined in Section 115(i) of the Revenue Act. Hammans vs. Commissioner, 121 F. (2d) 4, 7."

The only difference between that case and the case at bar is that there the reduction in the par value of the taxpayer's stock was effected by an exchange of the old stock for new stock having a less par value, while in the case at bar, the reduction in par value of the shares from $100.00 to $50.00 per share was effected by an endorsement on the certificates of stock held by the taxpayer. In that case there was a cash distribution of $45,240.00 to the taxpayer, and in ours there was a cash distribution of $23,706.00.

If there was a "partial liquidation", "in complete cancellation or redemption of a part of its stock", in the *Bedford* case, there was equally such a partial liquidation, within the sense and meaning of Section 115(i), in the case at bar.

CONCLUSION.

It is submitted that, in view of the plain conflict of decisions and the importance of the question, the writ prayed for should be granted and the decision of the Circuit Court of Appeals herein reversed.

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